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UNCLAS SECTION 01 OF 04 SAO PAULO 000005

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TAGS: ECON EFIN EINV ETRD BR
SUBJECT: BRAZILIAN CURRENCY DEPRECIATION: AFFECTING THE ECONOMY?

REF: A. Sao Paulo 0476; B. Sao Paulo 0680; C. Sao Paulo 0522; D. Brasilia 1427

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (U) Summary: Brazil's currency depreciated by more than 40 percent against the USD since the global financial crisis hit Brazil. The depreciation has less to do with Brazil's economic fundamentals and more with global risk aversion and the rush to U.S. Dollars. The strength of the Brazilian economy, coupled with Brazil's status as a net creditor, has mitigated the short-term macroeconomic implications; however, the Brazilian private sector is struggling to plan future investments in the absence of any exchange rate stability. The current conditions are very different than Brazil's last two currency crises of 1999 and 2002 when the causes were more endogenous to the Brazilian economy. The Brazilian Central Bank (BCB) has used its international reserve holdings much more frequently than in past years, but financial interlocutors believe the Bank has employed them in a more conservative manner than many in the private sector would like. The BCB has been more preoccupied with guaranteeing the supply of USD in foreign exchange markets than stabilizing the exchange rate; injecting USD 60 billion for export financing, spot market sales and repos, financing external debt, and covering foreign exchange derivative positions. Financial contacts do not see any change in the trend of the BCB's actions over the near-term. The BCB has a challenging year and several tough decisions ahead. End Summary.

Macro Picture Not So Bad

¶2. (SBU) Between September 1 and December 31, Brazil's currency the Real (BRL) was the most volatile currency in the world, depreciating against the U.S. Dollar by approximately 43 percent. The main causes of the rapid depreciation have been the massive outflows of portfolio investments and the global demand for USD amid global risk aversion. Although the long-term impacts remain undetermined, this time around, Brazil's stronger macroeconomic fundamentals have mitigated some of the short-term effects. Brazil's foreign reserve position, USD 207 billion, including USD 150 billion in U.S. Treasury bills, improves as the BRL depreciates relative to the USD and has helped the BCB maintain its reserves despite heavy USD intervention in foreign exchange markets. Likewise, Brazil's position as a net external creditor as of January 2008 means that depreciation has a net positive effect on its net debt to GDP ratio

because its USD reserves are greater than outstanding debt. Unibanco economists estimated that a 10 percent depreciation of the BRL translated to a decline in the public-sector net external debt to GDP ratio by approximately one percent. Brazil's net debt to GDP indicator declined by approximately five percentage points since September to 34.9 percent of GDP in December, which would have been 38.7 percent without the depreciation effect.

¶3. (SBU) While external debt has become less costly, the depreciation has contributed to an increase in internal government debt by USD 424 million. Currency depreciation makes imports relatively more expensive, while exports become cheaper worldwide. This time, however, slumping global demand for Brazilian exports and the freefall of commodity prices are likely to mean exports will not rebound as quickly. The Center for External Trade Studies Foundation (FUNCEX) estimated a 16 percent decline in the total value of exports for 2009; however, they expect a slight rebound in total volume of about five percent after sluggish growth of less than two percent in 2008 (Ref A). FUNCEX expects a slow-down of import volumes for 2009, estimating growth at six percent, following annual growth in 2008 of almost 20 percent. Finally, dividends and profits remittances are already showing a decline because of the exchange rate and lower asset prices, which should lessen the current account deficit (Ref A).

¶4. (SBU) Concerns over increases in inflation due to the BRL depreciation appear at this time to be overblown. Unibanco econometric models show that a 10 percent depreciation in the currency leads to a two percent increase in Brazil's inflation rate. Despite this, the BCB's fourth quarter inflation report stated that inflation was less of a risk now than earlier in 2008, and in fact

recent reports indicate a slight deflationary pressure in the economy. In its report, the BCB said that inflation is less of a concern for two central reasons: 1) strong domestic demand, one of the main drivers for consumer price inflation in 2008, has contracted sharply due to the global financial crisis; and 2) inflation indices have retreated in tandem with the decline of commodity prices (a 45 percent decline in USD prices for commodities since July). Because of the BRL depreciation, prices in BRL for Brazilian export commodities and imported goods have both been fairly stable because the BRL price for those goods remains unchanged at the new lower exchange rate.

Private Sector Very Concerned

¶5. (SBU) Most of the immediate and long-term concerns center on how the exchange rate volatility will affect the private sector and investment decisions. Greater price uncertainty due to exchange rate volatility makes it difficult to plan future investments. Indeed, many companies had sizeable foreign exchange derivatives positions to hedge against the BRL appreciation in the first half of 2008 that have resulted in significant losses for several big companies. So far, three prominent Brazilian firms, Votorantim (manufacturing, financing, new business), Aracruz (pulp), and Sadia (meat packing), have reported losses of approximately USD 2.5 billion, but some estimates are as high as USD 20 billion in exposure across the Brazilian private sector (Ref D).

¶6. (SBU) Roberto Giannetti da Fonseca, Director of Foreign Affairs at the Federation of Industries of Sao Paulo, said that it has been very difficult for the manufacturing sector to live without a reference exchange rate. Giannetti da Fonseca pointed to the daily trade volume decline as evidence that businessmen are unable to accurately plan for the future. In August, before the financial crisis, the average daily trade volume was USD 1.772 billion, while the average over the first 10 days of December was USD 1.395 billion (Refs B and C). According to Itau, business confidence is one of the best indicators of GDP growth for the coming quarter. The Fundacao Getulio Vargas (FGV) business confidence index declined by 11 percent from November to December to a 10-year low (October 1998 during the Russian crisis). The same survey showed capacity utilization down four percentage points from November and the indicator for future production was the lowest since January 1991.

Indeed, Brazil's Institute for Statistics announced that November's industrial production was down 5.2 percent from October, the largest drop in 13 years.

Not the Same as Last Two Adjustments

¶7. (SBU) The recent depreciation of the BRL is very different than Brazil's last two foreign exchange shocks in 1999 and 2002. The drivers for the 2008 depreciation are exogenous to the local economy, while earlier crises led to much deeper economic problems due to local variables. The current crisis is beyond the reach of domestic policies to curb the currency depreciation. Likewise, the current decline has occurred amid very different balance of payments financing conditions. Prior to 2003, foreign direct investment stock hovered around USD 150 billion, but was close to USD 600 billion when the crisis struck Brazil last year. Net external portfolio stock also soared from USD 20 billion at the end of 2003 and had reached USD 225 billion at the end of August 2008.

¶8. (SBU) Brazil's position as a net external creditor with its buildup of foreign reserves is another obvious improvement over previous crises. Because of this cushion, the BCB has been much more active in foreign exchange markets than in previous crises. The daily average consolidated intervention in the month of October surpassed more than threefold the largest monthly intervention during the 2002 crisis. From September to December, BNP Paribas estimated that the BCB injected approximately USD 70 billion into the Brazilian foreign exchange markets and to finance private sector external debt. One negative difference is the large foreign exchange derivatives positions that many Brazilian exporters held on their balance sheets, which elevated fears that the Brazilian banking industry could be affected.

What to Expect for 2009?

¶9. (SBU) The short answer is that no one really knows where the exchange rate will go in 2009. Market consensus in the last week of December for the 2009 exchange rate was R$ 2.25; however, the market has built in greater depreciation of the BRL into its 2009 estimates on a near weekly basis since September. Hitoshi Castro, head of Commercial Banking for Banco Fator told Econoffs that he believed the exchange rate would fluctuate between R$ 2.35 to R$ 2.65, but could spike as high as R$ 3.0. His rationale was that the downside risks of greater profit remittances, toxic derivatives (Castro thinks that 30 percent are still unaccounted for), the automotive industry crisis with some 250,000 cars in current inventories, and the high demand for forward foreign exchange contracts all imply greater depreciation of the BRL. Castro postured that an exchange rate of R$ 2.5 reduces the likelihood that Brazilians would pull deposits out of Brazil and that businesses in Brazil would limit repatriation of remittances, both good reasons for the BCB's current stance.

More BCB Intervention?

¶10. (SBU) The shortage of USD in the market has been a bigger concern for the BCB, and both the BCB and the GOB have pursued many measures to increase the USD liquidity in the Brazilian market (Ref D). Of the USD 70 billion the BCB injected from September through the end of 2008, the BCB used only USD 10 billion for spot market interventions to stabilize the BRL. Itau Securities noted that the BCB's primary actions have been USD credit lines for Brazilian exporters due to the shortage of USD in the market. Mauricio Oreng from Itau underscored that the BCB's actions do not suggest its behavior would change in 2009. Rather, he believes the BCB will continue its cautious management of reserves and limit the deterioration in quality of Brazil's reserve composition. Given market uncertainties for the duration of the crisis, he does not expect the BCB to react too quickly. In order to keep the reserves-to-imports ratio at a comfortable level, Oreng expected the BCB to limit its intervention to USD 65 billion. Likewise, Castro

does not expect the BCB to use its reserves to control the exchange rate, but on occasion the BCB could heavily intervene if the exchange rate hovered at R$ 3.0. Castro instead insisted that the BCB exploits its high reserve level to keep currency speculators at bay. (Comment: Castro explained that the stronger the reserve position, the greater the threat the BCB can make that it would intervene when it would hit speculators hardest. Specifically, he noted that the BCB could flood the market when movement is particularly low, which would have a sizeable effect on the exchange rate. This should keep currency traders from over-enthusiastic speculation. End Comment.)

Comment

¶11. (SBU) Over the medium term, Brazil's exchange rate is not likely to fall below R$ 2.0. The BCB has several tough choices ahead including the difficult decision of balancing the potential, if minimal, pressure of depreciation in consumer prices while maintaining positive economic growth by easing interest rates. Another consideration is how much the BCB intervenes in foreign currency markets to maintain the exchange rate. In the first part of 2008, the BCB faced intense pressure from exporters as the BRL appreciated and is now again facing harsh criticism from the domestic private sector to keep the exchange rate stable. Given that the sources of the BRL movement are mostly due to external forces, the BCB has a tough task ahead if it decides to intervene in an effort to limit exchange rate volatility. The exchange rate has proved an amazing, if unanticipated, hedge against the financial crisis. While uncertainties remain over the GOB's fiscal policy for 2009, the BCB, through its reserves policy, should remain a stabilizing force for fiscal policy. End Comment.

¶12. (U) This cable was cleared by Embassy Brasilia and with the U.S. Treasury Financial Attache in Sao Paulo.

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